This record is a partial extract of the original cable. The full text of the original cable is not available.

C O N F I D E N T I A L SECTION 01 OF 04 TEGUCIGALPA 000232

SIPDIS

TREASURY FOR U/S TAYLOR
TREASURY ALSO FOR RAMIN TOUOUI
STATE FOR WHA/CEN, WHA/EPSC, EB/IFD/OMA, AND DRL/IL
STATE PASS AID FOR LAC/CEN
DOL FOR ILAB

E.O. 12958: DECL: UPON SIGNATURE OF THE HONDURAN LETTER OF INTENT
OR DECL OF 03 TEGUCIGALPA 2792 (WHICHEVER COMES FIRST)
TAGS: EFIN ECON PGOV EAID ETRD EINV EPET ELAB HO
SUBJECT: HONDURAS IMF AGREEMENT FULL STEAM AHEAD -- PRIOR
CONDITIONS NOW FULFILLED AND BOARD APPROVAL OF PROGRAM
SCHEDULED FOR FEBRUARY 18

REF: A. 03 TEGUCIGALPA 2792

¶B. 03 TEGUCIGALPA 1581
¶C. PARIS 674
¶D. 03 TEGUCIGALPA 2915

Classified By: Ambassador Larry Palmer for reasons 1.5 (b) and (d).

¶1. (C) Summary. The Honduran government has fully completed the prior conditions listed in the preliminary Letter of Intent (LOI) for a three-year Poverty Reduction and Growth Facility Program (PRGF) agreed to with the IMF mission on November 25. In addition, the GOH has put to rest two new IMF concerns prompted by the flurry of measures taken in the last days of 2003. On January 20, the Congress modified significantly a problematic price control law and, also in mid-January, the government made further changes to the administration of the new fuels tax to comply with concerns by the principal oil product importers and distributors. Based on this progress, the IMF staff has negotiated a few remaining changes in the program, and the final Letter of Intent is due to be signed in Tegucigalpa on February 2. Honduras' PRGF will be considered by the IMF Board on February 18. Embassy recommends USG support for this hard-fought and long-awaited program. End Summary.

Key Elements of the Program

¶2. (C) As described in ref A, the central government deficit targets in the Honduran PRGF program are: 3.5 percent of GDP in 2004, 3.0 percent of GDP in 2005, and 2.5 percent of GDP in 2006. For the consolidated public sector, the deficit targets in the LOI are: 3.0 percent of GDP in 2004, 2.5 percent of GDP in 2005, and 1.7 percent of GDP in 2006. Central government wage bill targets are 10.6 percent of GDP for 2004, 10.4 percent of GDP for 2005 and 10.0 percent of GDP for 2006. Public sector wage bill targets are 10.4 percent of GDP in 2004, 10.0 percent of GDP in 2005, and 9.6 percent of GDP in 2006. The program also includes requirements for adoption of new financial sector reforms, overall civil service reform, a new tax code, and a prohibition on new agricultural debt bailouts.

The GOH's Concerted Efforts to Meet the Prior Conditions

¶3. (C) The Letter of Intent listed four prior actions, with which the Honduran government has now complied: adoption of a government salary law that reestablishes executive branch control of central government wage policy; adoption of a fiscal package of expenditure cuts and revenue measures that results in fiscal savings of one percent of GDP (about USD 60 million); adoption of a budget for 2004 that is consistent with expenditure reduction commitments in the program; and adjustment of the Poverty Reduction Strategy to reflect spending targets. The IMF also privately insisted upon the publication of a previously-decided hike in electricity rates.

The Long-Awaited Reining in of Government Wages

¶4. (SBU) On December 19, 2003, the Congress adopted Decree 220-2003, the Law on Restructuring of the Compensation System of the Central Government. It was signed by President Maduro on December 31, 2003, and published in the official La Gazeta on January 12, 2004. This law establishes executive branch control of public sector wage policy, folds the teachers into the unified civil service salary policy by January 2008, freezes the collateral benefits for public sector teachers at December 2003 levels, and freezes salaries for medical personnel in 2004 (with future increases tied to the rate of inflation). Planned salary increases for teachers for 2004 and 2005 have been reduced by half and stretched out over a three-year period (2004-2006). The legislation explicitly

overrides any previous legislation, effectively repealing the economic clauses in the special professional statutes that have resulted in the unsustainable growth in the central government wage bill in recent years. Decree 220-2003 directs the Finance Ministry to decide each year on government wage increases, based upon the availability of budget resources, using the projected rate of inflation as a guideline.

¶5. (SBU) The Congress changed the final law to put creation of a unified wage scale for teachers (to include basic salary plus benefits) in the hands of a special bipartite government-teacher commission. The IMF has added language to the program, explicitly requiring that the work of this commission be carried out in a manner consistent with the IMF program. The repeal of the economic clauses of the teacher and doctor statutes represents a major success by the GOH, as it is a basic structural reform that has been urged by the IMF and World Bank, and a few Honduran commentators, for years.

Austerity Measures

¶6. (SBU) Also on December 19, the Congress passed the Law of Rationalization of Public Finances, a new fiscal package of revenue and expenditure measures. It was signed by President Maduro on December 31, 2003, and published in the official La Gazeta on January 12, 2004. It includes steps that will reduce government spending and ensure better tax policy implementation. It freezes the number of government positions, except in health, education and security. It establishes a monthly salary cap of 60,000 lempiras (USD 3,300) for all public sector employees, including their collateral benefits. It freezes salaries in 2004 for employees with monthly salaries over 30,000 lempiras (USD 1,650). It directs government reorganization and cutbacks, including in the Honduran Foreign Service. Mining royalties and lottery proceeds will go directly to the government treasury.

¶7. (SBU) In early December, the government decided not to include in this law an increase in the tax on fuels in the fiscal package, but instead to reimpose a customs duty (between 10 and 12.5 percent, depending on the product) on fuel products by executive decree. This decree was put into place on December 31.

¶8. (SBU) The revised 2004 budget was adopted by the Congress on December 30 and published on December 31. It stayed within the expenditure constraints agreed upon by the IMF staff and GOH in late November. The fourth prior action, the revision of the poverty reduction plan and adoption of a monitoring process, was also completed in December. The IMF agreed to allow funds spent for salaries of public sector teachers and doctors to be counted in the tallying of the Poverty Reduction Strategy Paper (PRSP) spending, which brings government spending on these essential social services in alignment with the PRSP targets. The GOH also published, in December, the electricity commission's increase in electricity rates (as promised to the IMF).

The Fuel Tax Controversy

¶9. (SBU) The IMF has had strong reservations about the GOH's decision to raise the fuel tax instead of other broader revenue measures, primarily because of the impact on Honduran competitiveness and probable public outcry for this regressive tax. And, in fact, in an ill-advised attempt to avoid putting all the pressure on consumers and to avoid public criticism, close advisors to the President decided at the last minute to include in the fuel tax executive decree some unilateral changes to the formula used to determine the price of a gallon of fuel at the pump. The reference price used to estimate product cost was summarily changed from the Caribbean posting to the Gulf posting plus two cents. This simplistic move had been previously urged in August 2003 by former Minister of Industry and Trade Juliet Handal. Chevron-Texaco and Exxon reps told EconOffs that the Gulf posting price underestimates their costs by six cents, and thus this change pretty much wiped out the long-standing 4.7 cent per gallon margin that has been used in the formula for years. The companies were willing to reduce their margin somewhat, but were not able to accept an imposed arrangement that implied they would work for close to breakeven.

¶10. (C) Intense negotiations over the first two weeks of January resulted in a deal between the GOH and the oil companies in which a new decree was issued on January 23 that puts the reference price back to the Caribbean posting for three months while the GOH and oil companies negotiate a final settlement. In the meantime, Handal has been attacking the GOH in the press for leaving the impression in the press that the change in the pump price formula she had proposed

was the cause of the jump in gas prices (covering up the import duty). The GOH, after some obfuscation, has now satisfied the IMF staff that the revenue targets from the oil tax will meet revenue projections. The oil companies have purportedly agreed to absorb half of any price increase that may be required by the new formula during the first month.

A Problematic Price Control Decree Rolled Back Substantially

¶11. (SBU) Another complication developed on December 19, when the Honduran Congress decided to soften the blow of the fiscal measures by enacting a price freeze for six months on about 180 products (mostly foodstuffs). The Congress did not consult with the responsible Ministry, the Ministry of Industry and Trade, prior to the enactment of the measure. The Ministry currently monitors the prices of only 40 products and, with only twelve consumer protection inspectors, has little capacity to implement a price control system throughout the country. However, the IMF staff (and other economists) were concerned about the poor precedent set by this measure. Newspapers carried daily reports of price increases in the covered products and government's inability to curb them, putting the GOH under constant attack. The IMF immediately responded that a price control program was contrary to the letter and the spirit of the program, and insisted upon a rescinding of the law or drastic cutback in the number of products. Finally, on January 20, the Congress cut back the number of products covered to about 38, and the GOH agreed to a provision in the Letter of Intent agreeing to refrain from any further price controls for the life of the PRGF program.

Other Key Elements of the Program

¶12. (C) The GOH committed to enactment of a Financial Sector reform by June 2004 that will include a series of vital reforms for this very fragile banking system. The GOH will implement consolidated supervision of all financial intermediaries. Banks will be required to increase capitalization and provisioning for bad debts. There will be reforms to the Central Bank's role as a lender of last resort. This ambitious set of reforms is key to financial sector stability in October 2004, when the 100 percent government guarantee of bank deposits ends. The World Bank is implementing a financial-strengthening project to achieve these recommended reforms.

¶13. (C) The LOI includes mention of enactment of overall civil service reform in 2004. This is a key measure that was also included in Honduras' last PRGF program, and is a prior action for World Bank program loans. The IMF staff will be working closely with the World Bank to ensure the requirement is handled in a way that doesn't conflict with rules on cross-conditionality.

¶14. (C) The program requires enactment of a new tax code in 2004 that, among other things, provides harsher sanctions for tax evasion. The GOH has been working on the text of this law for some time. The GOH is also working with the Supreme Court to establish two special tax courts by the end of 2004.

¶15. (C) The IMF has also included a provision requiring the GOH to add more flexibility to its foreign exchange price band system, so that it could be used to cushion the economy from unanticipated shocks in the future if necessary. In recent years, the Central Bank has consistently bought and sold foreign exchange at a previously announced crawling peg rate, instead of letting the rate vary within its band.

¶16. (C) The final significant program requirement is a prohibition on new bailouts for agricultural loans and a limitation on expenditures to implement the 2003 Agricultural Credit law. The law authorized expenditures of up to two billion lempiras for agricultural debt forgiveness, but the GOH has committed to limiting the cost to 1.2 billion lempiras (USD 66 million) (shared between the GOH and the banks) and paying the smaller farmers first.

Comment

¶17. (C) Final evaluation of the program will have to await a review of the actual text of the Letter of Intent. However, it appears that after two long years, the Government has finally put together a credible macroeconomic program and the IMF has provided as much flexibility as is prudent and responsible. President Maduro, Congress President Pepe Lobo and the macroeconomic team can be justifiably proud of the work on reestablishing control over public sector salaries, increasing government revenues and making progress toward the goal of having the Honduran government live within its means. The program will help avoid further ill-advised

Congressional mandates, such as price controls and massive debt forgiveness for large agricultural interests, that have plagued government finances up to now. Protests resulting from congressional passage of these controversial measures have, to date, been muted (although a sizable demonstration on these issues is planned for February 5 (septel)). While not perfect (the heavy reliance on fuel taxes is one example), this program puts Honduras well on the way toward a period of stability, growth and investment in poverty reduction. Embassy recommends USG support at the February 18 board meeting. End Comment.

PALMER